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No. 71-669

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1971

UNITED STATES STEEL CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes involved	2
Statement	2
Argument	4
Conclusion	10

CITATIONS

Cases:

Anderson v. *Helvering*, 310 U.S. 404	7
Bankers Coal Co. v. *Burnet*, 287 U.S. 308	6
Burnet v. *Harmel*, 287 U.S. 103	6, 9
Burt v. *United States*, 170 F. Supp. 953	4, 10
Burton-Sutton Oil Co. v. *Commissioner*, 328 U.S. 25	7
Callahan Mining Corp. v. *Commissioner*, 51 T.C. 1005, affirmed on other grounds, 428 F. 2d 721, certiorari denied, 400 U.S. 903	4, 9, 10
Commissioner v. *Felix Oil Co.*, 144 F. 2d 276	7, 8
Douglas v. *Commissioner*, 322 U.S. 275	6
Fernandez v. *Wiener*, 326 U.S. 340	9
Freund v. *United States*, 367 F. 2d 776	6
Handelman v. *United States*, 357 F. 2d 694	4, 6, 10
Helvering v. *Mountain Producers Corp.*, 303 U.S. 376	7, 8
Higgins v. *Commissioner*, 33 T.C. 161	4, 10

Cases—Continued

	Page
Johnson v. *Phinney*, 287 F. 2d 544	6
Louisiana Land and Exploration Co. v. *Donnelly*, 394 F. 2d 273	4, 8, 10
McLean v. *Commissioner*, 54 T.C. 569	5
Palmer v. *Bender*, 287 U.S. 551	5
Poe v. *Seaborn*, 282 U.S. 101	9
Sneed v. *Commissioner*, 33 B.T.A. 478	6
Spalding v. *United States*, 97 F. 2d 697, certiorari denied, 305 U.S. 644	7, 8
Thornton v. *Commissioner*, P.H. Memo T.C., par. 70,321	5
United States v. *Boston & M.R. Co.*, 279 U.S. 732	5
United States v. *Davis*, 370 U.S. 65	9
United States v. *Mitchell*, 403 U.S. 190	9
United States v. *Thomas*, 327 F. 2d 119, certiorari denied, 379 U.S. 819	7, 8
Webster v. *Fall*, 266 U.S. 507	8
Wood v. *United States*, 377 F. 2d 300, certiorari denied, 389 U.S. 977	6

Statutes:

Internal Revenue Code of 1939 (26 U.S.C. (1952 ed.)):	
Sec. 23(m)	2, 3
Sec. 114(b)	2, 3

Miscellaneous:

Rev. Rul. 64-91, 1964-1 Cum. Bull. (Part 1) 219	10
Treasury Regulations on Income Tax (26 C.F.R.):	
Sec. 1.612-3(a)	6
Sec. 1.612-3(b)	6

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OPINIONS BELOW

The opinion of the district court (Pet. App. A 18a-39a) is reported at 270 F. Supp. 253. The opinion of the court of appeals (Pet. App. A 1a-15a) is reported at 445 F. 2d 520.

JURISDICTION

The judgment of the court of appeals was entered on June 22, 1971 (Pet. App. A 16a-17a). By order dated September 22, 1971, Mr. Justice Harlan ex-

tended the time for filing a petition for a writ of certiorari to and including November 19, 1971. The petition was filed on November 18, 1971. The jurisdiction of this Court is invoked under 28 U.S.C. 1254 (1).

QUESTION PRESENTED

Whether Minnesota ad valorem and royalty taxes, paid by lessees under iron ore mining leases, were excludable from the depletion base ("gross income from the property") of the lessees, and includable in the depletion base of the lessors, in calculating percentage depletion deductions under Sections 23(m) and 114(b)(4)(A) of the Internal Revenue Code of 1939.

STATUTES INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 are set forth in Appendix B to the petition (Pet. App. B 41a-42a).

STATEMENT

During the taxable year 1950, petitioner's subsidiary, Oliver Iron Mining Company (Oliver), was both lessor and lessee of iron ore mining properties in the State of Minnesota. All of the leases required the lessee to pay royalties, and further, to pay the Minnesota taxes on royalties and on the leased land, improvements and iron ore. For the year 1950, Oliver, as lessee, paid royalties to its lessors, and paid to Minnesota taxing authorities the local royalty taxes and the ad valorem taxes referred to immediately

above. Conversely, where Oliver was the lessor, its lessees paid royalties and the Minnesota royalty and ad valorem taxes. (R. 87a.)[1]

All of the leases under which Oliver was lessee or lessor provided for minimum annual royalties to be paid regardless of production, with the further provision that, in any year in which production exceeded the minimum tonnage, the excess royalties payable would be credited toward the minimum royalties of other years in which actual production was below that required to produce minimum royalties. Some of the leases also provided for a bonus payable by the lessee at the time the lease was signed. All of the leases were cancellable at the option of the lessee upon notice to the lessor of between six months and three years. (R. 59a, 64a.)

On audit for 1950, the Commissioner reduced Oliver's percentage depletion deductions, where it was the lessee, by excluding from its depletion base ("gross income from the property") the ad valorem and royalty taxes it had paid, on the ground that such tax payments constituted additional "rents or royalties" paid for the benefit of the lessors within the meaning of Sections 23(m) and 114(b)(4)(A) of the 1939 Internal Revenue Code. Conversely, in those cases where Oliver was the lessor, the Commissioner increased its depletion base by the amount of the tax payments made by its lessees. The decreases exceeded the increases by $304,323.54, which resulted in the

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[1] "R." references are to the separately bound Joint Appendix filed in the court of appeals.

assessment of a deficiency of $179,926.08. After payment of the tax in dispute, petitioner brought this suit for refund. (R. 87a-88a.)

The district court, ruling first that the law of Minnesota imposed the taxes involved on lessors of mineral properties, held that the payment of such taxes by a lessee constituted the constructive payment of additional "rents or royalties" which were includable in the depletion base of the lessor and, by the same token, excludable from the depletion base of the lessee. The court of appeals affirmed.

ARGUMENT

The decision below is correct. There is no conflict or any other reason for further review.

1. A uniform line of authorities is squarely in accord with the instant ruling that a lessee's payment of local taxes on a mineral property or production therefrom constitutes the constructive payment of additional royalties, includable in the depletion base of the lessor rather than the lessee, given the fact that the taxes involved would be payable by the lessor but for the lessee's undertaking to pay them under the lease. *Burt* v. *United States*, 170 F. Supp. 953 (Ct. Cl.) (Minnesota royalty and ad valorem taxes); *Higgins* v. *Commissioner*, 33 T.C. 161 (Minnesota ad valorem taxes); *Handelman* v. *United States*, 357 F. 2d 694 (Ct. Cl.) (Minnesota ad valorem taxes); *Louisiana Land and Exploration Co.* v. *Donnelly*, 394 F. 2d 273 (C.A. 5) (Louisiana severance tax); *Callahan Mining Corp.* v. *Commissioner*, 51 T.C. 1005, 1021-1022, affirmed on other grounds,

428 F. 2d 721 (C.A. 2), certiorari denied, 400 U.S. 903 (Idaho net profits tax); *McLean* v. *Commissioner*, 54 T.C. 569 (Minnesota ad valorem tax); *Thornton* v. *Commissioner*, P-H Memo T.C., par. 70,321 (Minnesota ad valorem tax).

2. The decision below and the authorities it follows are in accordance with sound principles. As this Court held in *United States* v. *Boston & M.R. Co.*, 279 U.S. 732, 734, payment by a lessee of business property of taxes on the property owed by the lessor, pursuant to the terms of the lease, is merely a "short cut" to payment of additional rentals to the lessor. In like manner, the court below explained (Pet. App. A 11a) that it is "rather fanciful to assume that in entering a lease agreement the lessee's contractual assumption of state taxes, which is obviously of value to the lessor, does not correspondingly reduce the amount of cash payments which the lessor receives from the lessee upon the extraction of the ore." In short, the payment of taxes by the lessee is in lieu of larger royalties.

It is true that the payment of taxes must be related to and dependent upon production in order to be attributable to the lessor's depletable economic interest, when paid on its behalf, and therefore includable in its depletion base. See, *e.g.*, *Palmer* v. *Bender*, 287 U.S. 551. But there is no basis for petitioner's contention (Pet. 9-11) that such dependence is lacking here. The dependence of the royalty tax on production scarcely need be labored. The ad valorem taxes on minerals are no less dependent upon production in the requisite sense. This conclusion follows as a

corollary from the settled rule that initial bonuses and advances or minimum royalties (which were provided for in the leases in question) are depletable income to the lessor, notwithstanding the fact that they are fixed amounts which may or may not be recouped by production. See, *e.g.*, *Burnet* v. *Harmel*, 287 U.S. 103; *Bankers Coal Co.* v. *Burnet*, 287 U.S. 308; *Freund* v. *United States*, 367 F. 2d 776 (C.A. 7); *Wood* v. *United States*, 377 F. 2d 300 (C.A. 5), certiorari denied, 389 U.S. 977. Such fixed payments are depletable in the first instance, subject to restoration of the depletion deductions to income if there is no production. *Douglas* v. *Commissioner*, 322 U.S. 275; Treasury Regulations on Income Tax (1954 Code), Section 1.612-3(a)(2) and (b)(2).

Bonuses and advances or minimum royalties are so treated because they are in contemplation or anticipation of production. *Johnson* v. *Phinney*, 287 F. 2d 544, 547 (C.A. 5). The Minnesota ad valorem taxes are in the same category. The lessee undertakes to pay them only because it anticipates their recoupment from production, and will terminate payment (by availing itself of provisions for cancellation such as those in the leases here) if production is insufficient to cover its expenses. See *Handelman* v. *United States*, *supra*, 357 F. 2d at 703.[2]

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[2] In contrast, delay rentals and shut-in payments are not depletable income to the lessor because they are made only for the failure to produce, or for the privilege of not producing, and are therefore not in contemplation of production. See *Johnson* v. *Phinney*, *supra*, 287 F. 2d at 545, 547; *Sneed* v. *Commissioner*, 33 B.T.A. 478.

The cases upon which petitioner relies (Pet. 10) in this connection (*Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25, and *Anderson* v. *Helvering*, 310 U.S. 404) are not to the contrary. They deal with payments—unlike those here—which are wholly unrelated to production.

3. Petitioner contends (Pet. 8-9, 11-13) that the instant decision and underlying authorities are in conflict with decisions which, it asserts, hold that a mineral lessor's depletable income is limited to the share of production expressly payable to the lessor under the lease, as royalties or otherwise. Petitioner cites *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376; *Commissioner* v. *Felix Oil Co.*, 144 F. 2d 276 (C.A. 9); *United States* v. *Thomas*, 329 F. 2d 119 (C.A. 9), certiorari denied, 379 U.S. 819; and *Spalding* v. *United States*, 97 F. 2d 697 (C.A. 9), certiorari denied, 305 U.S. 644. Its reliance on these decisions is misplaced.

In *Mountain Producers*, this Court held that the depletable income of a mineral lessor was comprised solely of the cash payments received and did not include any portion of the "expenses of production" which the lessee was obligated to bear under the terms of the lease. Petitioner contends that the taxes here were "expenses of production" and therefore, under *Mountain Producers*, not includable in the lessor's depletable income. But this argument fails to differentiate between the drilling and development expenses of production, traditionally borne by a lessee, and taxes which are primarily the obligation of the lessor. While it appears that taxes of some sort were

among the "expenses of production" involved in *Mountain Producers*, they were neither mentioned nor discussed in the Court's opinion. And, as the Court said in *Webster* v. *Fall*, 266 U.S. 507, 511, "Questions which merely lurk in the record, neither brought to the attention of the court nor ruled upon, are not to be considered as having been so decided as to constitute precedents."

Similarly, in *Felix Oil Co.* and *Spalding*, *supra*, while it appears from the records therein that taxes were included in the "expenses of production," there is no indication of the nature of those taxes or that the courts focused on the taxes as distinct from the other expenses. The silence of these courts on the proper allocation of taxes surely cannot be taken as approval of petitioner's position here.[3] As the Fifth Circuit explained in *Louisiana Land and Exploration Co.* v. *Donnelly*, *supra*, 394 F. 2d at 279—

> The difference between *Felix Oil Co.* and the *Burt* line of cases is that there was no question of *taxes* due by the lessor involved in *Felix Oil Co.* and it would have been improper to consider as gross income (for depletion computation purposes) production expenses *other than taxes* paid by lessee in the mining of the property, which expenditures were solely those of lessee *for which lessor had no liability.*

[3] *United States* v. *Thomas*, *supra*, is merely another factual version of *Mountain Producers*, and it does not appear from the opinion in that case that any taxes were included in the expenses of production.

Moreover, in *Callahan Mining Corp.* v. *Commissioner*, *supra*, although the lessor's depletion base was held to consist of a share of production income free of expenses of production, the Tax Court held that local taxes paid by the lessee were the primary obligation of the lessor, and hence includable in its depletion base.

4. Petitioner argues (Pet. 7-8) that the laws of various states differ from those of Minnesota in such fashion as to place the primary obligation for local taxes on the lessee, and, hence, that using the test of primary obligation derogates from nationwide uniformity in the treatment of local taxes for depletion purposes. Precisely the opposite is true. So long as taxes with a similar incidence are treated similarly for depletion purposes, the required uniformity is preserved. See *Burnet* v. *Harmel*, *supra*, 287 U.S. at 110; cf. *Poe* v. *Seaborn*, 282 U.S. 101, 110, 117-118; *Fernandez* v. *Wiener*, 326 U.S. 340, 358-359; *United States* v. *Davis*, 370 U.S. 65, 70-71; *United States* v. *Mitchell*, 403 U.S. 190, 197. And it may be noted that Minnesota is by no means alone in imposing taxes relating to mineral properties on lessors; as appears above, Louisiana and Idaho, at least, take the same approach.

5. The government is, of course, essentially a stakeholder in cases where the question is whether the lessor or the lessee shall include in its depletion base local taxes paid by the lessee. In order to avoid whipsaw, the Internal Revenue Service has ruled that it will oppose both the lessor and the lessee as litigants unless they agree upon an allocation of local

taxes between them. Rev. Rul. 64-91, 1964-1 Cum. Bull. (Part 1) 219. Since the successive decisions in favor of the lessor in *Burt*, *Higgins* and *Handelman*, however, the government has generally sided with the lessor, as in the instant case, and in *Louisiana Land and Exploration Co.* and *Callahan Mining Corp.*, *supra*. For the reasons stated above, we believe that the uniform line of authority in favor of the lessor is well grounded. At all events, given the unanimity of the authorities, there is no need for review by this Court at this time.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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